(7)

No. 683

IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

CHARLES HUGHES & COMPANY, INC.,
Petitioner,

against

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

DAVID V. CAHILL,
MURRAY R. SPIES,
Counsel for Petitioner.

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CASES CITED

STATUTES CITED

REGULATIONS CITED

(Securities Exchange Act of 1934)

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To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

The petitioner respectfully prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Second Circuit entered January 7, 1944, affirming an order of the Securities and Exchange Commission dated July 19, 1943, revoking the license of petitioner as a broker-dealer.

Opinions Below

The opinion of the Circuit Court of Appeals has not yet been reported, but it is printed at the end of the record submitted herewith.

Jurisdiction

The jurisdiction of this Court is invoked under Title 15, U. S. C. Section 78y, as amended by the Act of June 6, 1934.

Questions Presented

1. Whether as a matter of law there was any violation of Section 15 (c) 1 of the Securities and Exchange Act of 1934, or of Section 17 (a) of the Securities Act of 1933 by the petitioner, a dealer in securities, acting as principal, in its omission to state to the purchaser the market price of the securities sold or the amount of its mark-ups or profits when the purchaser did not ask for such information.

2. Whether there was prejudicial error on the part of the Commission in excluding proof that the securities sold by petitioner for investment purposes proved to be good and profitable investments.

3. Whether Section 15 (c) 1 of the Securities Act of 1934 is unconstitutional by reason of an unconstitutional delegation of power.

4. Whether the Securities and Exchange Commission by regulation X-15 C 1-2 has not exercised legislative power without authority of law.

Statutes and Regulation Involved

Section 15 (c) 1 of the Securities Exchange Act of 1934.

No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale

of, any security (other than commercial paper, bankers' acceptances or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive or otherwise fraudulent.

Rule X-15 C 1-2, Fraud and Misrepresentation.

(a) The term "manipulative, deceptive or other fraudulent device or contrivance" as used in Section 15 (c) (1) of the Act is hereby defined to include any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

(b) The term "manipulative, deceptive or other fraudulent device or contrivance" as used in Section 15 (c) (1) of the Act is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.

(c) The scope of this rule shall not be limited by any specific definitions of the term "manipulative, deceptive or other fraudulent device or contrivance" contained in other rules adopted pursuant to Section 15 (c) (1) of the Act.

Section 17 (a) of the Securities Act of 1933.

It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Statement

Petitioner is a corporation incorporated under the laws of the State of New York and was registered under Section 15 of the Securities Exchange Act of June 6, 1934 as a broker-dealer in securities. On or about February 13, 1942 the respondent made an order that proceedings be instituted to determine, among other things, whether the registrant had violated Section 15 (c) 1 of the Securities Exchange Act of 1934 and Section 17 (a) of the Securities Act of 1933, and whether it was necessary or appropriate in the public interest or for the protection of investors to suspend or revoke the registration of petitioner.

Charles Hughes & Company, Inc., is a New York corporation organized in April, 1940. "Charles" is the first name of a brother of Anne E. Hughes, president, and he was one of the organizers of the corporation in 1940. He has since retired from active participation in the firm. The corporation succeeded to the business of a trade-named association "Charles Hughes & Company" organized in 1937. This association had registered with the Securities and Exchange Commission in May, 1937. Subsequently the petitioner corporation filed an amended or supplemental registration statement with the Commission as a dealer-broker under Section 15 of the Securities Exchange Act of 1934. It has dealt (with persons) both as principal and as agent. In many of its transactions petitioner purchased stocks and bonds for its own account and as principal sold

them to various purchasers. During the entire period of its existence it conducted a general business in over the counter securities. Such securities are not listed on any of the exchanges. The price in a particular transaction is determined by negotiations between purchaser and seller.

The sales involved in this case are sales of over the counter securities. The securities sold by the appellant to its customers were in some cases owned by it before the sale and in others were either purchased shortly before, at the time or subsequent to such sale.

The appendix to the Commissioner's decision in this case consists of tables setting forth various transactions between the petitioner and many of its customers (R. pp. 16-20). Only three of these customers were called by the Commission to testify and give evidence at the hearings. The other customers did not appear at the hearing and no evidence as to them was adduced except the figures set forth in the appendix, which were taken by the Commission's agent from the petitioner's books and records. Therefore there is no complete picture of the transactions between them and the petitioner and no sufficient basis for determining the main issues with respect to their transactions. Apparently the Court below has assumed that the practices employed by registrant in dealing with these other customers were the same as those followed in dealing with the customers who testified. The Commission in its decision in a footnote said:

> "The record indicates that one of the three customer-witnesses was unreliable in certain respects, and we base no finding on that witness' testimony" (R. p. 12, footnote).

This reduces to two the number of witnesses, upon whose testimony the Commission based its findings.

The Court below also relied upon the testimony of these two witnesses, Stella D. Furbeck, one of the customers, and Ann K. Knebel, who testified about her dealings and the dealings of her mother, Pauline Engel. With the ex-

ception of a single disputed instance upon which the Commission made no finding or conclusion, neither of these witnesses testified to any misrepresentation on the part of registrant's representatives. Their direct testimony sought to establish complete reliance upon the salesmen and other representatives of registrant. It did tend to establish that the salesmen represented that the securities offered for sale were good investments and would increase their income. Both women confined themselves to generalities in their testimony. The securities sold were mainly bonds of railway and other corporations of a substantial type. The single instance of alleged misrepresentation was of so little value that, as stated above, the Commission failed to make any finding of fact based upon it. The Court below referred to the matter in these terms: "It is true that the only specific evidence of false statements of a material fact is that of Mrs. Furbeck that the sales price was below the market price, and, as we have noted, these statements were denied by the salesmen. Although the Commission has neglected to make any finding of fact on this point, we need not remand for a specific finding resolving this conflict, for we feel that petitioner's mark-up policy operated as a fraud and deceit upon the purchasers, as well as constituting an omission to state a material fact." It is clear, therefore, that the Court below did not treat the testimony on this disputed point as of any importance, but preferred to rely on the proposition that failure to disclose the market price or the mark-ups or profits made and the failure to disclose the market price were the bases of the alleged fraud.

The Securities and Exchange Commission has never made a regulation requiring a broker dealer acting as principal to state the market price to his customer and similarly has never made a regulation requiring the broker dealer to reveal his profits.

The evidence showed that the petitioner acting as principal made gross profits on its transactions with the two customers referred to and the other customers shown in

the appendix to the Commission's opinion (Rec. pp. 16 to 20) averaging approximately 26%. The Court below at the end of its decision described the profit as 25%.

There is no evidence of misrepresentation or false statements either as to the nature or value of the securities sold. No worthless stocks or bonds were sold to the customers. At the hearing before the Commission efforts were made to bring out that if the purchasers had retained their securities they would have increased their income and principal, but these efforts were frustrated by objections and by rulings of the Examiner (R. pp. 45-47).

POINT I

The omission on the part of petitioner to state to its purchasers the market price of the securities sold or the amount of its mark-up or profits when the purchasers did not ask for such information, as a matter of law did not constitute a violation of either Section 15 C-1 of the Securities Exchange Act of 1934, or Section 17 (a) of the Securities Act of 1933.

The Court below in its opinion affirmed the decision of the Commission apparently upon the ground that the omission to state the market price or the mark-ups was an omission to state a material fact required to be stated under Section 17 (a) 2 of the Securities Act of 1933 and also operated as a fraud and deceit upon the customers under subdivision 3 of the same statute. Section 15 C-1 of the 1934 Act forbids the use of the mails or any interstate instrumentality for the purpose of bringing about the purchase or sale of any securities by any "manipulative, deceptive, or other fraudulent device or contrivance" but does not define the terms "manipulative", "deceptive" or "fraudulent". The Commission is authorized to make the definition by rules and regulations. It will be argued later that this constitutes an unconstitutional delegation of power,

but for the present that point will be passed as not pertinent here. The Commission in regulation, Rule X-15 C 1-2, defines the terms "manipulative, deceptive or fraudulent" in precisely the same language as Section 17 (a) 2, but adds that the statement or omission in order to be within the terms of the definition must be made "with knowledge or reasonable grounds to believe that it is untrue or misleading". The record is devoid of any evidence whatsoever to establish that there was any knowledge or that there were reasonable grounds to believe that the omission to disclose the market price or the profits tended to or did mislead the customer or to make any statements to them misleading. Therefore, under both statutes the question is whether there was "any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading". The Commission did not make any rule or regulation requiring a dealer acting as principal, as this petitioner was, to state the market price to purchasers or to reveal the extent of its mark-ups. But the Commission in its interpretation of the statutes and its own regulation has read into them an implication that a failure to state to a customer the market price is an omission of a material fact required to be stated within the terms of the statutes and regulation.

If there was any intention at the time to make such a requirement it was concealed by the Commission under the general terms used, which gave the broker dealer no fair warning of the requirement. The Commission had the general subject in mind. As a matter of fact it embodied a requirement in its own Rule X 15 C-1-4, the essence of which is that the dealer acting as principal complies with its duty to its customer under this rule by disclosing that he is acting as a principal. It is significant that in the same rule the Commission, having no doubt taken into consideration the difference in the relationship of a dealer acting as principal with its customers and, on the other hand, a dealer acting as broker or agent with its customers, re-

quired only of the latter that he disclose certain information normally required of a fiduciary such as "the source and amount of any commission or other remuneration received or to be received by him in connection with the transaction". The use of the words "or other remuneration" indicates that a broker or agent may also lawfully make a profit, but if he does he must disclose it as well as any commission involved. The adoption of this rule, in terms inapplicable to a dealer acting as a principal, makes it clear that the position of the respondent in the case at bar, requiring the dealer principal to disclose his profits is an after-thought. When it adopted Rule X 15 C 1-4 requiring a broker-agent to disclose his profit it could at the same time and in the very same rule have required the dealer acting as principal to disclose his profit or the market price of the security or both. It is significant that although the Commission had adopted a number of specific regulations governing the operations of brokers and dealers, it left the subject of the violation involved in this case to mere implication. Rules X 15 C 1-5, X 15 C 1-6 and X 15 C 1-8 deal specifically with items of information which a dealer is required to disclose in dealings with customers and the dealer is subject to penalties for violating these rules. They embody also the definitions of the terms "manipulative", "deceptive" and "fraudulent". The first of these rules dealing with failure to disclose common or joint control of an issue of securities by a broker or issuer, and the second requiring disclosure of an interest on the part of the seller in the distribution of securities, are obviously inapplicable here. Rule X 15 C 1-8 deals with "Sales at the Market". It defines as "manipulative, deceptive or otherwise fraudulent" the following:

> "Any representation made to a customer by a broker or dealer who is participating or otherwise financially interested in the primary or secondary distribution of any security which is not admitted to trading on a national securities exchange that such security is being offered to such customer 'at the market' or at a

> price related to the market price unless such broker or dealer knows or has reasonable ground to believe that a market for such security exists other than that made, created or controlled by him * * *."

This rule makes it clear beyond the possibility of argument that the Commission had in mind the specific subject of market price and any misrepresentation with respect to that subject. If it had intended that the market price of a security or the relation of the sales price to the market price, was a material fact required to be disclosed to a purchaser, it could have embodied the requirement in language as clear as the regulation just quoted and this obviously would be the fair method of dealing with the subject. As the matter stands it is left to implication, with no clear warning of the implied duty given to the dealer and the alleged violation in this case rests upon what we urge is an unfair and illogical implication both of the statute and the regulation. It is a reasonable inference that the Commission's failure to make a specific rule on this subject was due to its reluctance to state expressly the extraordinary claim of power made by the Commission under cover of this rule, the power to fix prices or regulate profits.

The primary fact to be noted in this connection is that neither in the statute nor the regulation involved herein has there been any statement or suggestion that the market price is a material fact, required to be stated by a dealer acting as a principal. No dealer or other person reading the statute and the regulation could receive any warning from them that he was required to state the market price to his customers and that a failure to do so would subject him to the penalties, civil and criminal, imposed by the statutes. It would have been simple to state this requirement, and it would be necessary to do so in order to apprise any person concerned of the penalties or the liabilities to which he would be exposed for failure to state the market price. The requirement that the dealer acting

as principal should state also the relationship of the market price to the sales price, or the extent of his profits similarly is not contained in the regulation nor is the dealer given notice of any such requirement.

In this case there was not a single statement of fact made which could possibly be affected by the omission to state the market price if any existed. The statements made by the representatives of petitioner to the customers were true. There is no proof of any false statements. It can neither be assumed nor proved on the record herein that any of the true statements made became misleading by reason of the fact that the salesmen failed to state the market price to the customers. There has been no demonstration by the respondent nor by the Court itself that the omission to state the market price under these circumstances operated as a fraud upon the purchasers of securities. In fact, the conclusion is inevitable upon this record that no fraud was committed against any of the purchasers of securities from petitioner, but on the contrary securities of real value were sold to them for investment purposes, and if retained by them pursuant to their original objective those securities would have proved to be precisely as represented—good and profitable investments. This would have been demonstrated if the Commission had accepted proof of all the material facts when offered. Certainly the presumption even on the incomplete state of the record, resulting from the Examiner's narrow ruling, would favor the petitioner.

The whole theory upon which the implied requirement of a statement of the market price is based is in purpose and effect an attempt to fix prices for dealers acting as principals. Under this theory, as applied in the case at bar, the Commission gives to itself the right to decide whether a particular sale of securities is a good bargain for the customer and to punish the dealer if the Commission decides that he is not offering a good bargain. If the dealer makes a profit which the Commission arbitrarily decides is more than he is entitled to under the circum-

stances, it may revoke his license and apply to him the criminal penalties prescribed by the statute. There is no limit to the power thus claimed and no way in which a dealer can determine in advance how it may be used in the particular case. The test of fairness is obviously variable and varies not only according to the facts of the various transactions, but according to the judgment of the Commission, which under their theory is entirely uncontrolled.

The device of insisting upon a statement of the market price is plainly a means of obtaining for the Commission a power not given by the statute nor even embodied in a regulation. It is an attempt on the part of the Commission to set itself up as a price-fixing body. The Commission claims it is not interested in how much profit a dealer acting as a principal can realize on a sale but that it is interested in having the dealer disclose the market price. This attempted distinction is too subtle for serious practical consideration in a court of law. It is a case of a distinction without a difference. That the Court below is of the same opinion is shown by the fact that in its opinion it refers interchangeably to the omission to disclose mark-ups and the omission to disclose market price as the material fact omitted and as the fraud allegedly perpetrated. Had proper and sufficient proof been permitted to be adduced on the part of petitioner, a statement of the market price would be found to be immaterial. The statutes and the regulation do not call for such disclosure in any specific terms. When it is noted that the revocation here is based upon a finding that omission to state such "material fact" results in a willful violation of the Securities Acts and that a willful violation lays the basis for criminal prosecution carrying with it possible severe penalties, the well established principle of law that such statutes penal in nature must be construed strictly should apply. In this case the Commission is resting upon the purely negative aspect of the regulation, because it has not been able to prove any untrue statements of fact by the petitioner's representatives. The materiality of the omitted statement must be

tested in the light of the true statements made by petitioner. These true statements made by the petitioner do not become misleading by reason of the failure on the part of the salesmen to give information as to the market price or the extent of his profits, neither of which the customers requested nor as a matter of fact were interested in. The making of the statement as to the market price or the extent of the petitioner's profits would not make the treatment of the customer any fairer, nor does the omission to make such statements make the dealing with the purchasers unfair. The Commission by its action is, in effect, taking the position that the entire security purchasing public (whether informed or uninformed in the "devices of Wall Street") is its ward and that even though the customer does not complain and is satisfied with his bargain, consummated without any misrepresentations, and even though the transaction has made a profit for him over and above the dealer's profit, the Commission may step in at any time and punish the dealer for not disclosing the market price or the extent of his profits. The decision, as it now stands, makes potential criminals of the hundreds if not thousands of security dealers throughout the nation whose books and records may disclose a mark-up or a profit which, upon belated analysis by the Commission's representatives, may seem to them, at the time, to be "excessive". Furthermore, with no formula legally possible for measuring what shall be a proper differential between market price and sales price, the door becomes open wide to the thousands of bargain hunters who may now come in to set aside—not all of their transactions with dealers—but only those which have not made enough profit for them, using as their plaint the cry of fraud and unfairness based upon nothing more than the omission on the part of a dealer to disclose the market price or the profit involved.

Respondent's reliance upon the assumed confidential relationship between dealer and purchaser, tantamount to a fiduciary relationship, is required by the exigencies of its present case. The law with respect to fiduciary rela-

tionships and the duties of fiduciaries is neither so vague nor so elastic as the Commission would have it for present purposes. It is not applicable to any and every case, in which a seller inspires confidence in a purchaser. The Commission's theory of confidential relationship and resulting duties, conveniently vague in expression and application, should be properly accredited as an original conception. As an excuse for requiring a disclosure of market price and profits and of course a regulation of profits, it is more ingenious than ingenuous. A frank regulation dealing with the subject in express terms should not be avoided.

Under Section 202 of the Investment Advisers Act (see Appendix at the end of this brief) a dealer and his salesman are permitted to give investment advice without registering as Investment Advisers or becoming such. We do not find under that Act or elsewhere in the Securities Acts any indication that the giving of such advice creates a new duty on the broker, that of disclosing either the market price or the extent of profits, nor do we believe the lawful giving of such advice was intended to create a new relationship in law between two individuals dealing as principals with each other.

Moreover, the dealer apparently is not required at all times and under all conditions to reveal the profit or the market price, but only when that profit is too large or the differential between the market and sales price is too great in the changing judgment of the Commission. The dealer can never tell what the Commission's judgment of a transaction may be until the transaction itself has been completed and a violation, if any, committed. As to the existence of a fiduciary relationship between petitioner acting as principal and its customers, it rests upon a gratuitous assumption. Therefore, to assume that such a relationship exists and to deduce from that assumption new duties, the omission of the performance of which violates the statutes and the regulation, is to beg the question. There is no applicable common law on the subject. The Commission concedes that petitioner was acting as a principal herein.

We have used the term "fiduciary relationship", because we find no other term that would express the relationship of trust and confidence, which the respondent assumed in its own consideration of the case and in the Court below.

As far as the case of the dealer acting as principal is concerned, there is no requirement whatever either expressed or reasonably implied requiring the dealer acting as principal to disclose the market price and the extent of his mark-ups. This meaning had to be read into the statutes and into the Rule X 15 C 1-2). It is urged that a fair interpretation of the statute and the regulation involved will not bring this new requirement (new as far as a principal is concerned) within their terms. It is not too much to say that in the general terms of the statutes and the regulation in question, a trap has been laid for the dealer acting as principal, by which he may be led unsuspectingly into the civil and criminal liabilities prescribed by the statutes. To adopt the reasoning of the commission and of the lower Court would be in effect to destroy for all practical purposes the long established common law rule of *caveat emptor*. The practical effect of the decision of the lower Court is to convert all dealers into fiduciaries. This was not the intent of the Congress nor was it the express intent of the Commission itself.

POINT II

There was prejudicial error on the part of the Commission in excluding proof that the securities sold by petitioner were as represented, good and profitable investments.

This was the essence of the statements made by the various salesmen and representatives of the petitioner to the two customer witnesses who testified for the Commission. The Court below in its opinion stressed the alleged statements of petitioner's representatives that certain securities offered were "wonderful" and "a marvelous buy"

and "beyond the usual". It cannot be reasonably contended that a salesman does not have the right to use such descriptive terms if in his opinion they are appropriate and applicable to the article being offered for sale. Therefore, when such terms are cited and relied upon by the Court to lay, by implication and innuendo, a basis for revocation of a valuable franchise, the accused was entitled to establish the soundness of the investment offered. This it was not permitted to do. Throughout its decision the Court below indicates a feeling that the dealer here imposed upon the two customers who testified. This is evidenced by the Court's reference to these two witnesses as either "single women or widows". The Court added its own conclusion that in one instance one of these women customers was induced to add a security to her previously acquired collection, "selling a more reputable security in order to finance the transaction". There is no evidence whatever in this case that any of the securities were less reputable than those previously acquired. As a matter of fact when petitioner's representatives sought to prove not only that the securities were reputable but that they would bring an increase both in principal and income to the purchasers, the Commission excluded proof of these facts (R. pp. 46, 47). The Court below probably overlooked the one-sided nature of the Commission's inquiry. The Commission sought to convey the impression that securities of a less desirable type than those already held by the investors were being foisted upon them by petitioner, by refusing to permit petitioner to show the truth, that investments in the securities offered by it had resulted in some instances and would result in other instances in an increase of both principal and income. The Court below evidently overlooked this point, which in view of the Court's own conclusions was vital, and the resulting error was obviously prejudicial.

In passing it may be noted as a matter of common knowledge that a salesman may be expected to be, and ordinarily is, enthusiastic in his description of whatever article he

offers for sale, and that in the absence of any misrepresentation of fact such enthusiasm is not to be treated as vicious either in nature or purpose. The Court below was apparently diverted by these considerations from the main questions presented for review here and reached a conclusion unfavorable to petitioner on the basis of assumptions and incomplete information. If the nature and value of the securities in question formed any vital part of the case, the subject would merit, and the questions of fact would require, a complete inquiry by the Commission, with an opportunity to petitioner to present the facts fully. No basis for the Court's conclusion was laid in the record. It is impossible to determine from it, whether the stocks proved to be good investments or not, because petitioner was prevented from bringing out the facts by the objection of the Commission's attorney and the rulings of its examiner. If there was a warranty in this case that the securities sold were fit for investment it was serious and prejudicial error on the part of the Commission to exclude evidence offered by the petitioner that the securities sold by it proved to be good and profitable investments. This proof, if received by the Commission, would have disposed of this case completely. There would be nothing left of the charge of unfairness.

POINT III

Section 15 (c) 1 is unconstitutional because it makes an unconstitutional delegation of power.

The statute itself demonstrates the point. In essence it forbids the use of the mails or any instrumentality of interstate commerce to effect a transaction or induce the sale of any security by means of "manipulative, deceptive or other fraudulent" devices or contrivances. Then the statute makes this extraordinary provision: "The Commission shall, for the purposes of this subsection, by rules and

regulations, define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent." Congress made no attempt to define these terms and established no standard upon which a definition could be based. The terms are not self-definitive and there are no common law definitions to which resort may be had. Therefore, whatever the Commission might choose to say was "manipulative", "deceptive" or "fraudulent" became so under this act of Congress, and the penalties, criminal and civil, prescribed by the Statutes follow upon the Commission's legislative act of definition.

The Court below in support of its decision upholding the constitutionality of this statute, cited *Buttfield* v. *Stranahan*, 192 U. S. 470. There is no analogy between the cases. The statute involved in that case, the Act of March 2, 1897, 27 Stat. 604, Section 1, 2 prohibited the importation of teas "of inferior purity, quality and fitness for consumption" under standards which the Secretary of Treasury was authorized to fix and establish upon the recommendation of a board of experts in teas. Obviously it would have been impracticable for Congress to prescribe standards of purity and fitness for consumption in detail. No such argument can possibly apply to the use of such terms as "manipulative", "deceptive" and "fraudulent".

Recent illustrations of the principle involved are found in *Panama Refining Co.* v. *Ryan*, 293 U. S. 388, and *Schechter Corp.* v. *United States*, 295 U. S. 495. In the *Panama Refining Co.* case Chief Justice Hughes, writing the opinion, pointed out that the statute did not qualify the President's authority, or state conditions or circumstances for its exercise and did not require any findings of fact as a condition or declare any policy, and the Court added:

"So far as this section is concerned, it gives to the President unlimited authority to determine the policy, to lay down the prohibition, or not to lay it down, as he may see fit. Any disobedience to his order is made a crime punishable by fine and imprisonment." The same criticism applies to the statute in question here. The Commission is

given power to make any definition whatever of the terms "manipulative, deceptive and fraudulent" in its uncontrolled discretion and for that matter has power to change the definition from time to time as it may see fit to do. The license of petitioner in this cause was revoked for a violation of the regulation and rests upon the definition contained in that regulation. Insofar as this statute is employed as a basis for the Commission's action, it is without authority of law. In passing it may be said that the definition contained in the regulation follows substantially the language of Section 17 (a) of the Securities Act of 1933, Subdivisions 2 and 3. Because of its vagueness and uncertainty, the validity of the regulation is seriously questioned.

The question as to the constitutionality of Section 15 C-1 of the 1934 Act does not necessarily involve any question as to the constitutionality of Section 17 (a) of the 1933 Act for the reason that in the 1933 Act no authority to define the terms "manipulative", "deceptive" and "fraudulent" is given, as it is expressly given in the 1934 Act. Therefore, the observation of the Court below in its opinion that the question of the constitutionality of the 1934 Act should be disregarded because no question has been raised as to the constitutionality of the 1933 Act, is unfounded in fact and in reason.

Finally it must be noted that rule X-15 (c) 1-2, subdivision b, adds an element not contained in subdivision 17 (a) of the 1933 Act, subdivision 2. After proscribing any untrue statement of a fact or an omission to state a material fact the rule adds these words: "which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading". The statutes are not identical and the regulation does not conform precisely to either.

POINT IV

The Commission by Regulation X-15 C 1-2 has exercised legislative power without authority of law.

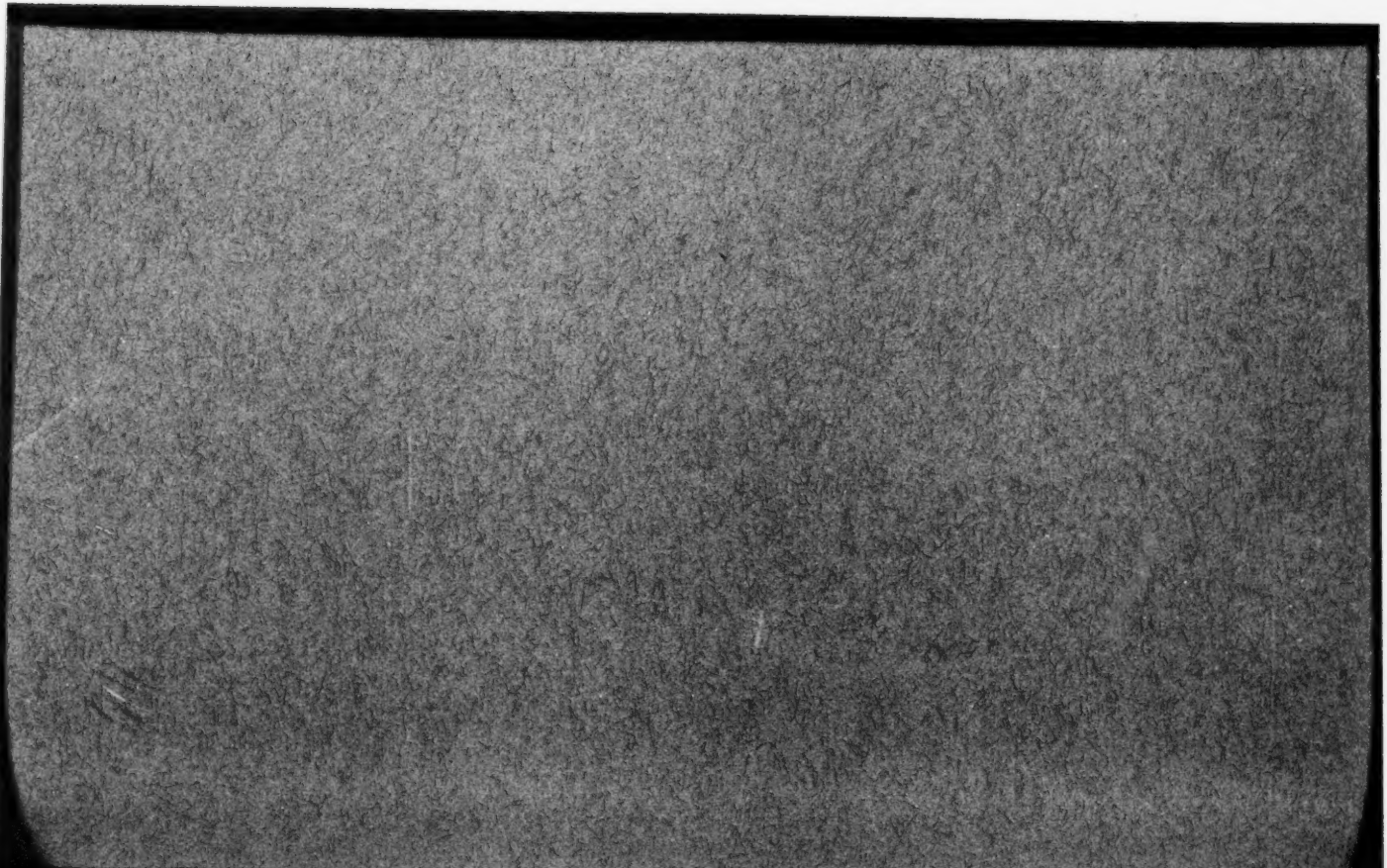
The conclusion follows from what has already been stated. The definition of the terms "manipulative, deceptive and fraudulent" is a legislative act. Section 15 (c) 1 of the 1934 Act was incomplete until it was followed up by the legislative act of the Commission in defining those terms.

CONCLUSION

This Court has never passed upon the points presented herein, nor has any other Court done so, except the Court below in this case. It is a question of wide application, arising in thousands of transactions throughout the country. The application presents important questions of Federal law, which should be settled by this Court in order to afford guidance to the security dealers of the country and to thousands of others interested personally. Under the circumstances it is urged that the exercise of this Court's supervisory jurisdiction is required.

Respectfully submitted,

David V. Cahill,
Murray R. Spies,
Counsel for Petitioner.



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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 683

CHARLES HUGHES & COMPANY, INC., PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINION BELOW

The findings and opinion of the Securities and Exchange Commission are set forth in the record at pages 6–20. The opinion of the circuit court of appeals (R. 185–191) affirming the order of the Commission is reported in 139 F. (2d) 434.

JURISDICTION

The order of the Securities and Exchange Commission under review was entered on July 19, 1943 (R. 21). The decree of the circuit court of appeals affirming the order of the Commission was

entered on January 3, 1944 (R. 192). The petition for a writ of certiorari was filed on February 9, 1944. The jurisdiction of this Court is invoked under Section 25 (a) of the Securities and Exchange Act of 1934 (15 U. S. C. § 78y (a)).

QUESTIONS PRESENTED

1. Whether petitioner's sales of securities to its customers involved fraudulent and deceptive practices within the meaning of the Acts administered by the Commission.

2. Whether Section 15 (c) (1) of the Securities Exchange Act of 1934 involves an unconstitutional delegation of power.

STATUTES INVOLVED

The pertinent provisions of the statute and regulations appear in the Appendix, *infra,* pp. 17–18.

STATEMENT

Acting under the authority of Section 15 (b) of the Securities Exchange Act of 1934 (15 U. S. C. § 78o (b)), the Securities and Exchange Commission, by an order dated July 19, 1943, revoked the registration of the petitioner as a broker and dealer (R. 21). The circuit court of appeals affirmed this order.

Petitioner is a corporation, organized under the laws of the State of New York, and maintains its principal office and place of business in the City

of New York. It is engaged in over-the-counter[1] trading in securities as a broker and dealer, and is registered as such with the Commission pursuant to Section 15 (b) of the Securities Exchange Act.

During the course of the revocation proceeding, it was shown that between May, 1940, and August, 1941, the petitioner's total sales of securities to its customers consisted of fifty-six transactions, and that in twenty-seven of these transactions the price charged by petitioner was from 16.1% to 40.9% in excess of the prevailing market price (R. 16–20, 97). A substantial portion of these transactions were riskless, in the sense that the securities were acquired by the petitioner after confirmation of sale to the customer (R. 16–20). Petitioner has never denied the excessive charges and has never attempted to explain them as justified by special circumstances, but has insisted on its right to make the charges. The Commission held these transactions to be fraudulent in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934, and revoked petitioner's registration as a broker-dealer.

ARGUMENT

I

In this case the petitioner raises as its first issue a question as to the construction of the anti-fraud

[1] The term "over-the-counter" is used in this memorandum to refer to securities transactions otherwise than on an exchange.

provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. On this main issue there is no conflict of decisions; indeed, this is the only case in which the courts have as yet been called upon to determine the validity of the particular principle which the Commission has followed. Further, we believe the case has been correctly decided.

However, we do not oppose the issuance of the writ since the principle involved has been followed by the Commission in a number of administrative proceedings, and is the basis of a large segment of the Commission's fraud-prevention activities, and the question is, therefore, of substantial public importance and of importance to the Commission in administering its statutes. We discuss the question presented in both its legal and economic aspects in aid of a determination whether further review is warranted.

(a) THE COMMISSION'S HOLDING

The Commission found that the petitioner had wilfully violated Section 17 (a) of the Securities Act, Section 15 (c) (1) of the Securities Exchange Act, and Rule X–15C1–2, adopted under Section 15 (c) (1). These sections are almost identical in content, and outlaw fraud in securities transactions. The Commission held that a securities dealer, by reason of the very nature of his business, impliedly represents to all his customers that he will deal with them honestly and fairly, and in

accordance with the established standards of the business, and that this vital representation is rendered false, and a fraud or deceit is practiced upon the customer, when a dealer charges prices not reasonably related to the prevailing market price without disclosing that fact (R. 11). The Commission has applied this doctrine in a number of proceedings beginning in 1939,[2] but this is the first case in which review has been sought for the purpose of directly challenging the principle.

(b) THE CASE WAS CORRECTLY DECIDED BELOW

We believe that the decision of the Commission and of the court below was correct. The petitioner states the basic question accurately when it poses the issue in terms of the application of "the long established common law rule of *caveat*

[2] *Duker & Duker*, 6 S. E. C. 386 (1939); *Jansen and Company*, 6 S. E. C. 391 (1939); *G. Alex Hope*, 7 S. E. C. 1082 (1940); *Allender Company, Inc.*, 9 S. E. C. 1043 (1941); *Jack Goldberg*, Securities Exchange Act Release No. 3110; *Scott McIntyre & Co.*, Securities Exchange Act Release No. 3235; *W. K. Archer & Co.*, Securities Exchange Act Release No. 3253, affirmed without consideration of the question here at issue in 133 F. (2d) 795 (C. C. A. 8th), certiorori denied, 319 U. S. 767; *William J. Stelmack Corp.*, Securities Exchange Act Release No. 3261; *Jack Lewis Baker*, Securities Exchange Act Release No. 3311; *Trost & Co., Inc.*, Securities Exchange Act Release No. 3345; *Theodore T. Golden*, Securities Exchange Act Release No. 3404; *Lawrence R. Leeby*, Securities Exchange Act Release No. 3450; *Guaranty Underwriters, Inc.*, Securities Exchange Act Release No. 3481. Copies of those opinions in this list which have not yet been reported are being filed with the Clerk.

emptor" to sales by a securities dealer (see Pet. p. 15). The Commission's view is that that rule, insofar as it retains any vitality as a general rule of law,[3] has been drastically modified by the securities laws in its application to transactions between security dealers and investors. The basic assumption of the securities legislation is that in the light of the special position of the dealer and of the very nature of securities, investors require special protection. As the President said in his message to Congress recommending passage of the Securities Act of 1933: "This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware'. It puts the burden of telling the whole truth on the seller".[4]

Securities are, in the words of Congress, "intricate merchandise."[5] The business of trading in them is one in which "opportunities for dis-

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[3] Cf. *Federal Trade Commission* v. *Standard Education Society*, 302 U. S. 112, 116, where this Court said: "The best element of business has long since decided that honesty should govern competitive enterprises, and that the rule of *caveat emptor* should not be relied upon to reward fraud and deception."

[4] H. Rep. No. 85, 73d Cong., 1st sess. (1933), p. 2.

[5] H. Rep. No. 85, 73rd Cong., 1st Sess. (1933), p. 8. After this report, there was a very thorough Congressional investigation into securities market abuses, and into the need of investors for protection against insiders, which laid the foundation for the Securities Exchange Act. "Stock Exchange Practices," Hearings before Committee on Banking and Currency on S. Res. 84, 72d Cong., and S. Res. 56 and S. Res. 97, 73d Cong. (1933, 1934).

honesty are of constant recurrence"; and securities frauds tend to take on "more subtle and involved forms" than are found in less specialized activities. *Archer* v. *Securities and Exchange Commission,* 133 F. (2) 795, 803 (C. C. A. 8th, 1943), certiorari denied, 319 U. S. 767.

The experience of the Commission reinforces the legislative conclusion that the position of the securities dealer is so highly specialized that the investor, as a practical matter, must rely largely on the dealer's integrity. This is true particularly in the over-the-counter market, where the investor does not even have the safeguards afforded by the stock exchange. There are no ticker services or central agencies where a prospective customer can check the prices at which over-the-counter securities are being traded. Newspapers publish bid and asked quotations in only a relatively few securities and those quotations are of unproven accuracy. On the other hand, private services, together with steady trade contacts, available only to the dealer, give him information not obtainable by his customers. The investor "is chiefly dependent for his knowledge of prices and quotations upon the house with which he deals."[6]

[6] Report to Congress by the Securities and Exchange Commission, entitled "Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker" (1936), at p. 66.

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Thus, whether the investor be experienced or inexperienced in securities matters, the dealer is, from the very circumstances of the case, in a position of superior knowledge. And a position of superior knowledge, where the same information is not equally available to both sides, carries with it an obligation to deal fairly.[7] In other words, the situation is such that the buyer necessarily relies on the seller's special knowledge and skill and the seller is aware of this. Under the circumstances, the seller impliedly represents or warrants that the buyer will get what he "expects to get."[8] In the case of securities the investor "expects to get" the securities at a price reasonably related to the prevailing market. An investor considering a small lot of securities which have a market readily able to absorb them would no more expect to buy those securities if he could dispose of them immediately only at a substantial loss, than would a housewife expect to buy eggs unfit for human consumption. For just as other commodities are thought of in terms of their use, so securities are, to a great extent, thought of in terms of market price and their value rests largely

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[7] *Stewart* v. *Wyoming Cattle Ranche Co.*, 128 U. S. 383, 389; *Strong* v. *Repide*, 213 U. S. 419; *Liland* v. *Tweto*, 19 N. D. 551, 125 N. W. 1032, 1037–38.

[8] *Cushing* v. *Rodman*, 82 F. (2d) 864, 868–869 (App. D. C.); *Hoe* v. *Sanborn*, 21 N. Y. 552. The doctrine has been incorporated into Section 15 of the Uniform Sales Act.

on the fact that they can be converted into money.[9] In fact, the price charged for securities is, as the circuit court stated, "the point of ultimate consequence" (R. 191). Under the circumstances, it is clear that current securities legislation, in the language of the court below, would be "little more than a snare and a delusion" if the public could not "rely upon a commission-licensed broker not to charge unsuspecting investors 25 per cent more than a market price easily ascertainable by insiders". The court noted that it is the very purpose of such legislation to prevent the sale of "securities which are in fact worthless or worth substantially less than the asking price" (R. 191).[10]

Petitioner makes several arguments which require brief comment.

First, the Commission is not seeking, as suggested by the petitioner (Pet. pp. 10–12, 14), to

[9] *Cf.* Berle and Means, *The Modern Corporation and Private Property* (1932), pp. 281–287, 306–307. This Court has referred to securities as "the equivalent of money." *Geddes* v. *Anaconda Copper Mining Co.*, 254 U. S. 590, 598.

[10] There was evidence tending to show that petitioner's salesmen approached widows and housewives with little, if any, experience in business matters, won their trust and confidence, and then proceeded to abuse that trust and confidence by selling them securities at excessively high mark-ups. See the Commission's Opinion at R., pp. 10–14. The Commission held that these facts served to make the fraudulent nature of petitioner's activities more evident, but did not regard them as essential to, or determinative of, the case.

limit profits as such. The Commission is concerned only with the relationship between the price charged and the prevailing market price. This is not, as petitioner implies, equivalent to a limitation on profits. For example, if a dealer purchases a security at $25 the Commission's construction would impose no limitation, by way of market disclosure, or otherwise, on his right to sell that security at a later date for $50 or $100 if there has been a corresponding rise in the market level in the interim.[11]

Second, petitioner makes much of the fact that Rule X–15C1–2 does not in specific terms outlaw sales at a price bearing no reasonable relation to the market. The answer, of course, is that if the transaction is fraudulent in nature, it need not be proscribed otherwise than in the general prohibition of fraud. The only effect of attempts to make hard and fast rules concerning the types of conduct which are fraudulent and those which are

[11] Petitioner also intimates that the Commission's ruling requires dealers to disclose market price to their customers at all times and under all circumstances (Pet. pp. 8, 10, 11; but see p. 14). This is inaccurate. The Commission simply maintains that the sale of securities by a professional dealer, if effected at a price bearing no reasonable relationship to the prevailing market price, is a fraud upon the customer, unless, of course, there is full disclosure of the significance of the excessive charge. Thus, there is no duty of disclosure to the customer unless the price charged bears no reasonable relationship to the prevailing market price.

not is to make room for evasion.[12] And, of course, the Commission's view that transactions of the type here involved are fraudulent were made public in 1939, well before the transactions here complained of.[13]

Third, petitioner devotes a whole point in its petition (Point II) to the fact that it was not permitted to prove that the securities sold would bring increased income to the purchasers. The evidence rejected was of no materiality to the issue. It did not purport to show that petitioner's implied representation concerning the market was true. It purported only to show that other representations concerning interest or dividends were true. The truth or falsity of representations concerning earnings of the securities sold was not in issue at the hearing and could not affect the implied misrepresentation concerning market price.

An examination of the basis of the Commission's holding and the nature of the objections to that holding, we submit, establishes that the case was correctly decided by the court below, and that

[12] See *State* v. *Whiteaker*, 118 Oreg. 656, 247 Pac. 1077, 1079, where the court stated that if a hard and fast rule were laid down "a certain class of gentlemen of the 'J. Rufus Wallingford' type—'they toil not neither do they spin'—would lie awake nights endeavoring to conceive some devious and shadowy way of evading" the rule. *Cf.* also *Federal Trade Commission* v. *R. F. Keppel & Bro., Inc.*, 291 U. S. 304, 312, and *Federal Trade Commission* v. *Raladam Co.*, 283 U. S. 643, 648.

[13] See list of Commission opinions cited in footnote 2, *supra*, p. 5.

that court properly held that "the Commission has correctly interpreted its responsibilities to stop such abusive practices in the sale of securities" (R. 191).

(c) THE PUBLIC IMPORTANCE OF THE QUESTION

Some 5,000 brokers and dealers are registered with the Commission under Section 15 (b) of the Securities Exchange Act. Their offices are scattered all over the country, in every State and every town. Their sales of over-the-counter securities are believed to amount to at least $10,000,000,000 annually. In this market most of the brokers and dealers purport to act as principal and not as agent. There is no organized market place and although the newspapers publish some quotations, this applies only to a very small percentage of the securities traded. Unlike stock-exchange trading, there is no established commission, fee, or profit for the effecting of transactions. As a result of these circumstances, a great number of cases have come to the Commission's attention involving the sale of securities at prices greatly in excess of prevailing market prices. In many cases the investor is uninformed and the transactions are accompanied by high-pressure selling.[14]

[14] For a discussion of this problem see testimony of Commissioner (now Chairman) Purcell of the Securities and Exchange Commission before the House Committee on Interstate and Foreign Commerce, under the title *Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934*, 77th Cong., 1st Sess. (1941–42), Part I, pages 85–88.

The Commission's approach has been to deal with the matter on a case-to-case basis under its powers to revoke broker-dealer licenses and to initiate criminal prosecution for fraud. The National Association of Securities Dealers, an association organized under Section 15A of the Securities Exchange Act of 1934, has adopted a rule providing that prices shall be fair in the light of all the surrounding circumstances. The Association has another rule requiring its members to observe just and equitable principles of trade. The Board of Governors of the Association has informed the membership that it regards the latter rule as requiring members to charge prices reasonably related to the current market price.[15]

Since the field of price in the over-the-counter market has been until recently completely unregulated, the validity of the position taken by the Commission and by the N. A. S. D. is a question of

[15] The policy of the National Association of Securities Dealers is reflected in the recent decision of a District Business Conduct Committee imposing censure and a fine of $500 upon a dealer whose mark-ups over the prevailing market price approximated 10 percent. See the *NASD News* of October 1943 (pp. 5, 7), copies of which are being submitted to the Clerk. A recent study of the mark-ups over the current market actually taken by members of the National Association of Securities Dealers shows that 47% of the transactions were effected at a gross mark-up over the current market of not over 3%, and 71% at not over 5%. The Board of Governors of the Association has circulated these statistics among the members for their guidance. See *New York Times*, October 26, 1943, page 31.

great moment to over-the-counter dealers generally, and there has been considerable discussion among them as to its necessity and propriety. Regardless of any steps which may be taken by broker-dealer associations, the position which the Commission has taken in the present case—i. e., that sales at prices bearing no reasonable relation to the prevailing market price are fraudulent if made without appropriate disclosure—is the cornerstone of the Commission's whole policy of preventing excessive charges in the over-the-counter market.

II

SECTION 15 (C) (1) OF THE SECURITIES EXCHANGE ACT OF 1934 INVOLVES NO UNCONSTITUTIONAL DELEGATION OF POWER

The petition also attacks the anti-fraud section of the Securities Exchange Act of 1934 on the ground of unconstitutional delegation of legislative power to the Commission.

The circuit court correctly described petitioner's objections in this respect as "insubstantial" (R. 188). And there is no conflict of decisions on this point, since the particular provision has never been challenged before.

Section 15 (c) (1) states that the Commission may "by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent." Petitioner contends that

the Congress has neglected to provide a standard for the guidance of the Commission, and that the subsection constitutes an unconstitutional delegation of power (Pet. pp. 17–19). It is clear that the words "manipulative, deceptive, or otherwise fraudulent" are themselves a standard. See *Buttfield* v. *Stranahan,* 192 U. S. 470. Standards far less definite have been approved by this Court.[16]

Further, the Commission found that the petitioner's acts were fraudulent under Section 17 (a) of the Securities Act of 1933 as well as under Section 15 (c) (1) of the Securities Exchange Act of 1934. Since the petitioner's charge of unlawful delegation does not extend to Section 17 (a) (and cannot since it involved no delegation of power), the validity of Section 15 (c) (1) is not really involved, and petitioner's argument on this point, as the court below stated, appears frivolous (R. 188).

This question, accordingly, presents no basis for the issuance of a writ of certiorari.

CONCLUSION

By reason of the public importance of the question considered under Point I of this Memo-

[16] See, e. g., *Tagg Bros. & Moorhead* v. *United States*, 280 U. S. 420 ("just and reasonable" as a guide in rate making); *Federal Radio Commission* v. *Nelson Bros. Co.*, 289 U. S. 266 ("public convenience, interest, or necessity," "fair and equitable allocation").

randum, we do not oppose the issuance of a writ of certiorari; but we suggest that the writ if issued should be limited to that question.

Respectfully submitted.

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APPENDIX

Section 17 (a) of the Securities Act of 1933 (15 U. S. C. § 77q (a)) provides:

> (a) It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 15 (c) (1) of the Securities Exchange Act of 1934 (15 U. S. C. § 78o (c) (1)) provides:

> No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent

device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

Rule X–15C1–2, adopted under Section 15 (c) (1) of the Securities Exchange Act of 1934, reads as follows:

RULE X–15C1–2. FRAUD AND MISREPRESENTATION.

(a) The term "manipulative, deceptive, or other fraudulent device or contrivance," as used in section 15 (c) (1) of the Act, is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

(b) The term "manipulative, deceptive, or other fraudulent device or contrivance," as used in section 15 (c) (1) of the Act, is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.

(c) The scope of this rule shall not be limited by any specific definitions of the term "manipulative, deceptive, or other fraudulent device or contrivance" contained in other rules adopted pursuant to section 15 (c) (1) of the Act.

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